

***United States Court of Appeals
for the Second Circuit***



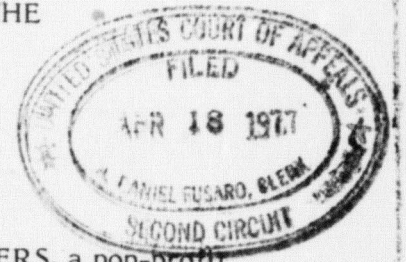
**PETITION FOR
REHEARING**

77-6010

PETITION FOR REHEARING

UNITED STATES COURT OF APPEALS FOR THE
SECOND CIRCUIT

No. 77-6010



NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit
association, BRISTOL OPTIONS INC., CHARTERED SYSTEMS CORPORATION,
CLEARY TRADING COMPANY, INC., FIRST NEW YORK COMMODITY
OPTIONS, LTD., FIRST WESTERN COMMODITY OPTIONS, INC. OF
LOS ANGELES, WILLISTON CORPORATION, LLOYD, CARR AND
COMPANY and INTERNATIONAL COMMODITY
OPTIONS, LTD.,

PLAINTIFFS-APPELLANTS-CROSS APPELLEES

v.

THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY,
Chairman COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, II,
Vice Chairman COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS,
Commissioner COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN,
JR., Commissioner COMMODITY FUTURES TRADING COMMISSION AND ROBERT
L. MARTIN, COMMISSIONER COMMODITY FUTURES TRADING COMMISSION,
DEFENDANTS-APPELLEES-CROSS APPELLANTS

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

LEONARD R. GOLDSTEIN
Attorney for Appellants-
Cross Appellees

MARTIN H. KAPLAN
DAVID GREENE
Local Counsel for Appellants-
Cross Appellees

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PRELIMINARY STATEMENT

The plaintiffs-appellants-cross appellees National Association of Commodity Options Dealers ("NACOD"), and others hereinafter collectively known as "plaintiffs," by their undersigned attorneys, hereby petition the Court for a rehearing pursuant to Rule 40(a) of the Federal Rules of Appellate Procedure of the Judgment of April 4, 1977 which reversed a preliminary injunction granted by the District Court for the Southern District of New York on January 6, 1977, and affirmed the District Court's grant of summary judgment on the remaining issues. (JA 500-526). The District Court had preliminarily restrained and enjoined the defendants-appellees-cross appellants Commodity Futures Trading Commission and individual members thereof ("Commission") from enforcing Commission Regulation 32.6, which requires dealers in commodity options to segregate ninety percent (90%) of proceeds from customers in special accounts in the United States until the option either lapses or is exercised, and "all rights" of the option customer "under the commodity option have been fulfilled", ("double segregation"), but granted summary judgment upholding the other regulations promulgated by the Commission to regulate commodity options trading. Plaintiffs further pray that issuance of the mandate be stayed, pending a disposition of this Petition, pursuant to rule 41(a) of the Federal Rules of Appellate Procedure. As grounds and good cause for this Petition, plaintiffs maintain that the Court overlooked or misapprehended the following points of law or fact in its April 4 Opinion;

1. The Court applied the wrong legal standard in reversing the preliminary injunction in that it did not find the District Court had abused its discretion in granting the injunction, but found only that it had "erred."

2. The Court applied the wrong legal standard in reversing the preliminary injunction in that it did not consider whether the factual determinations supporting the preliminary injunction were clearly erroneous, but

rather substituted factual contentions made by the Commission, without reason or explanation.

3. The Court erred in reversing the preliminary injunction in that the preliminary injunction was a proper exercise of the District Court's authority and discretion to preserve the status quo pendente lite, in light of the applicable facts and circumstances.

4. The Court erred in affirming the grant of summary judgment upholding the remaining regulations in that there were controverted issues of material fact, and the Commission was not entitled to judgment as a matter of law.

ARGUMENT

I. THE COURT SHOULD REHEAR THE REVERSAL OF THE PRELIMINARY INJUNCTION AND APPLY THE PROPER STANDARD OF REVIEW

Appellate review of a preliminary injunction is narrowly circumscribed. Issuance of a preliminary injunction whatever its form, is within the discretion of the District Court, and will not be disturbed absent a showing of mistake or abuse of discretion. Jacobson and Co., Inc. v. Armstrong Cork Company, 548 F.2d 438, 441 (2nd Cir., 1977); Triebwasser & Katz v. American Tel. and Tel. Co., 535 F.2d 1356, 1358 (2nd Cir., 1976); Brown and Williamson Tobacco Corporation v. Engman, 527 F.2d 1115, 1121 (2nd Cir., 1975). In affirming a grant of a preliminary injunction in Doran v. Salem Inn, Inc., 422 US 922 (1975) the Supreme Court stated, "the standard of appellate review is simply whether the issuance of the injunction in light of the applicable standards, constituted an abuse of discretion." 422 U.S. at 933. Here the Court has transcended the limited review, and has usurped the function of the District Court by substituting its own judgment. The April 4, 1977 Opinion is devoid of any application of the "abuse of discretion" standard. Rather, the Court concludes merely that "the district judge erred in granting plaintiffs a preliminary injunction against the segregation requirements." (emphasis supplied)

(Slip op., p. 2664). Such a standard of review is, of course, appropriate in a case which has been fully litigated on the merits below. However, a preliminary injunction serves the purpose of maintaining the status quo pending a final determination, and is specifically not an adjudication on the merits. Diversified Mortgage Investors v. U. S. Life Title Insurance Co. of New York, 544 F.2d 571, 576 (2nd Cir., 1976). The Court should have applied the more liberal standard of review and should reconsider its Opinion in light of whether the District Court abused its discretion.

II. THE COURT SHOULD REHEAR THE REVERSAL OF THE PRELIMINARY INJUNCTION AND APPLY THE PROPER STANDARD OF FACTUAL REVIEW

In reviewing a preliminary injunction, a Court of Appeals may not disturb the findings of facts underlying that injunction unless such findings are "clearly erroneous". Federal Rules of Civil Procedure 52(a). Such findings may not be rejected out of hand, and will stand if supported by evidence. United States v. El Paso Gas Co., 376 U. S. 651, 656-657 (1964). The lower court's findings of fact in granting a preliminary injunction must be accepted unless clearly erroneous under the stringent standard of Rule 52(a). Union Management Corporation v. Koppers Company, Inc., 366 F.2d 199 (2nd Cir., 1966).

A comparison of the memorandum granting the preliminary injunction (JA 500-527) and the April 4 Opinion reveals that the Opinion is predicated upon factual findings diametrically different from those of the District Court, without the requisite determination that the lower court's findings were "clearly erroneous."

The District Court found,

"The only reason stated for this admittedly harsh action was the need for speed to protect the public. The Commission does not cite, and we cannot find, any reason or fact which had come to its attention since the rules were proposed in February without any provision for segregation which would seem to justify this need for haste. (footnote

omitted). Such haste seems especially unjustified in view of the admittedly harsh consequences of the rule and the Commission's continuing search for alternatives." (emphasis supplied) JA-513.

The Court concludes that it did not appear "that the Commission accepted the requirement with undue haste" (Slip op. p. 2663), but does not demonstrate how, if at all, the District Court's contrary finding is clearly erroneous. Rather, it substitutes the conclusory contentions of the Commission for the requisite factual finding.

The District Court further decided;

"Therefore, with respect to the regulation requiring segregation, it is our conclusion of fact that plaintiffs are threatened with irreparable injury in that, being required by the necessities of their business to forward to their principals in London the premiums for options they sell to their customers (representing at least 75% of the funds received from customers), they could not long remain in business if required to segregate in the United States an amount equal to 90% of such funds (footnote omitted). It is our conclusion of law that - for the reasons above outlined - plaintiffs have a reasonable likelihood of success on the merits of their attack on the segregation requirement. We further conclude, in light of the wide panoply of regulations already and about to be in effect, that the public interest will not be adversely affected by preliminarily enjoining these segregation requirements." (emphasis supplied) (JA-514).

Certainly the finding of the District Court that plaintiffs stand to suffer irreparable injury is not clearly erroneous. Uncontroverted affidavits in the record of this proceeding clearly support the finding that imposition of the segregation requirement will drive the commodity options specialty houses from the business, and leave the business to those few heavily capitalized general securities houses who have the cash flow to implement double segregation. (See e.g. Affidavit of John Forma, JA-48, 53; Affidavit of John Forma, JA-345 et seq; Affidavit of Peter E. Aaron, JA-442, 455-458). The Court never discusses the catastrophic effect double segregation will have on the options industry except to say that "it threatens to restrict participation in the industry to soundly capitalized firms." (Slip op. p. 2663).

The Court substitutes its own factual findings for those of the District

Court by merely reiterating the contentions of the Commission in place of finding fact;

"And the Commission has pointed out that financially stable firms may be able to meet the capital demands of segregation by borrowing, and using the interest they can obtain on the segregated funds to defray a good part of the cost of borrowing." Slip op. p. 2662.

The District Court however, with the record before it, noted "The Commission's suggestion that this could be accomplished by bank financing is not persuasive." Note 29a, JA-524.

The Court reverses the District Court's finding that the public interest will not suffer from preliminarily enjoining the segregation requirement without any finding of clear error or marshalling of contrary fact from the record. The capstone of the reversal is the determination that the segregation requirement was a "reasonable exercise of its (the Commission's) discretion in an effort to protect the public. . ." (Slip op., p. 2664). The Court does not conclude - nor can it conclude from the record below - that the District Court's finding that the full panoply of regulations available to the Commission is sufficient to protect the public is clear error. Rather, the Court merely speculates that in the absence of segregation, "a need for capital might prod a dealer into over-dependence on customers' money to finance general operations." (Slip op. p. 2662). There is no evidence in the record of this proceeding which gives any support or credence to this speculation. Furthermore, double segregation will not remedy any possible over-dependence by a dealer on customers' funds because without double segregation, most of the proceeds are forwarded immediately to London as payment for the options, out of the control of the dealer. Viewed most cynically, a dishonest dealer would find it far easier to misappropriate funds segregated in the United States than to misuse monies which are immediately transmitted abroad. The Court goes on to say, "The Commission's conclusion that in light of past abuses,

the public now needs this minimal protection carries great weight." (Slip op. p. 2663). However, as the District Court knew, the draconian decree of double segregation, which will succeed in putting the industry out of business, is hardly "minimal protection," but rather is a requirement without precedent in any other part of the securities or commodities business, or any other sphere of commerce. Furthermore, nowhere in the record has any "past abuse" been documented which could have been prevented or remedied by double segregation and which cannot be prevented or cured by the arsenal of regulations now in the hands of the Commission. Nor has the Commission filed any letters from the public demanding the implementation of segregation. The only "past abuses" cited by the Court are two Securities and Exchange Commission cases involving factual situations several years old and not current cases brought under the Commodities Exchange Act, (Slip op., p. 2661). The Commission is unable to cite one pending "abuse" which might have been cured or remedied by the drastic medicine of double segregation.

Thus, the Court should rehear and reconsider the reversal of the denial of the preliminary injunction in light of the proper standard to be applied in reviewing factual determination by the lower court.

III. THE COURT OVERLOOKED AND MISAPPREHENDED THE APPLICABLE LAW AND FACTS IN REVERSING THE PRELIMINARY INJUNCTION

The Court erred in reversing the preliminary injunction in that the plaintiffs satisfied all criteria in the lower court for the granting of a preliminary injunction. The normal function of a preliminary injunction is a preservation of the status quo pending a determination on the merits. Triebwasser and Katz v. American Tel. and Tel. Co., supra, 535 F.2d at 1360.

The Court has set forth two alternative tests for the issuance of a preliminary injunction:

- a) probable success on the merits and possible irreparable injury; or

b) sufficiently serious questions going to the merits to make them a fair ground for litigation and a balance of hardship tipping decidedly toward the party requesting preliminary relief. Sonesta International Hotels Corp. v. Wellington Associates 483 F.2d 247, 250 (2nd Cir., 1973); Triebwasser and Katz v. American Tel. and Tel. Co., *supra*, 535 F.2d at 1358.

The Court's April 4 Opinion did not review the grant of the preliminary injunction in the context of either of the alternative Sonesta tests. If the Court had, it would have had no choice but to affirm the grant of the preliminary injunction pendente lite, as the plaintiffs satisfied both alternative tests.

The District Court properly concluded that the plaintiffs satisfied the first of the Sonesta tests. (JA 512-514). The plaintiffs clearly demonstrated probable irreparable injury, in that unless double segregation were enjoined, they would be forced out of business, which would totally upset the status quo. The plaintiffs also demonstrated success on the merits in the following respects:

1) The Commission acted arbitrarily and capriciously in hastily imposing a regulation which the Commission concedes will have the effect of driving most options houses from the industry and leave commodity options trading in the hands of a few securities houses. Such action not only violates all notions of fundamental fairness, but it is patently unlawful. Section 15 of the Commodity Exchange Act, 7 U.S.C., Section 19 (Supp. V 1975), states in pertinent part: "The Commission shall take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of this Act, as well as the policies and purposes of this Act, in issuing any order or adopting any Commission rule or regulation. . ." (emphasis supplied).

The Commission could not have taken a more anti-competitive measure than double segregation if it had tried. Rather it breached its statutory duty by imposing a regulation with which only a few major wire houses can live and which

will destroy competition in the options industry.

2) Double segregation is arbitrary and capricious in that it is a novel, bizarre device imposed only in the commodity options industry. The defendant Commission can point to no analogy in any other field of commerce, whether in the securities or any other industry, in which customers' funds must be retained, in the regular course of business, particularly after the customer has received the full benefit of his bargain; i.e., the option has been purchased for him as promised. The burden is increased in that the regulation puts no bounds on the period during which a customer's funds must be segregated. Segregation must be imposed "until all rights of the option customer under the commodity option have been fulfilled." In the event of a dispute over the option, and subsequent litigation to determine their "rights" thereunder, a customer's funds could remain in segregation for years. No normal business could function under such a restraint; business must reinvest proceeds to purchase inventory and meet overhead. The imposition of such a requirement on only the commodity options business and none other is punitive and a creature of caprice.

3) Double segregation is arbitrary and capricious in that investor protection does not require so odious and burdensome a means, especially in light of the other regulations available to the Commission. The Commission has pointed to no fraud that double segregation would have prevented, nor can it prevent a fraud by a determined malefactor now. The Commission has filed no letters from investors or consumer advocates urging that double segregation be imposed.

Furthermore, double segregation would not protect an investor in the event of bankruptcy of the options house. The segregated accounts would be part of the estate of the bankrupt, and the investors would be in the lowly position of unsecured creditors, whose interests would be subordinated thereby. Even the July Advisory Committee Report, which recommended segregation, noted that segregation might not protect investors in the event of the insolvency of the

dealer. The Report states at page 48:

"The Advisory Committee understands that the legal efficacy of segregation imposed by regulation is uncertain....(T)he Advisory Committee recommends that the Commission seek appropriate legislation to assure that full recognition be given under the bankruptcy laws to assets segregated for the benefit of customers pursuant to Commission requirements." (emphasis supplied) (JA-157).

4) Double segregation is arbitrary and capricious in that it is not needed to protect American investors from defalcations or failures at the foreign options clearing houses. An uncontroverted affidavit by James Carr states that in 128 years of operation, there has not been one failure to perform on an options contract by either the London Metals Exchange or the International Commodities Clearing House, the two London houses where the commodity options at issue here are written. (JA-496).

Certainly the plaintiffs satisfied the alternative second Sonesta test. As discussed, the District Court properly found that the plaintiffs would suffer the most severe kind of irreparable harm by being put out of business. Therefore, the burden of hardship tipped clearly to the plaintiffs vis-a-vis the Commission, which still wields an impressive array of regulations, including a stringent anti-fraud provision (Regulation 32.9).

Furthermore, the plaintiffs presented serious litigable issues going to the ultimate question of whether the Commission acted arbitrarily and capriciously in promulgating the segregation regulation. The grant of the preliminary injunction, the lengthy record engendered by this litigation, and the discussion supra of how the segregation regulation is arbitrary, capricious, and an abuse of administrative discretion, all demonstrate clearly that the plaintiffs presented meritorious litigable issues.

The double segregation rule has been imposed by administrative caprice, without careful thought as to what wrongs it was to remedy, how it would be

implemented, how it would function and who would be hurt. At the minimum, the Court should restore the preliminary injunction, and remand for discovery and full trial on the merits.

IV. THE COURT OVERLOOKED AND MISAPPREHENDED
THE APPLICABLE LAW AND FACTS IN
AFFIRMING SUMMARY JUDGMENT

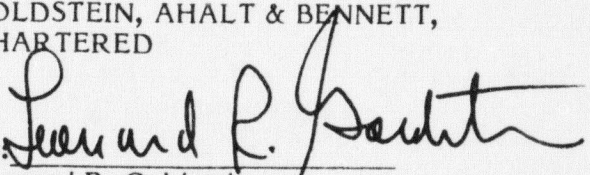
Rule 56(c) of the Federal Rules of Civil Procedure allow the granting of a motion for summary judgment only when there is no genuine issue of material fact, and the movant is entitled to a judgment as a matter of law. The movant has the clear burden of demonstrating both these elements. Adickes v. S. H. Kress and Company, 398 U.S. 144 (1970). Viewed in light of this statutory burden, the Court's affirmance of the District Court's grant of summary judgment in favor of the Commission on the challenged regulations other than the double segregation regulation was not appropriate. Whether the Commission acted arbitrarily and capriciously in promulgating stringent regulations which, as the Court pointed out, have probably already damaged plaintiffs' business (Slip op. p. 2666), is a question of fact. The Court should not have accepted the untested justifications of the Commission for its actions, but should vacate the premature summary judgment for further discovery and trial on the merits.

V. CONCLUSION

For the reasons stated hereinbefore, the Court should rehear the April 4 reversal of the preliminary injunction, and affirmance of the grant of summary judgment and should restore the preliminary injunction pending full trial on the merits.

Respectfully submitted,

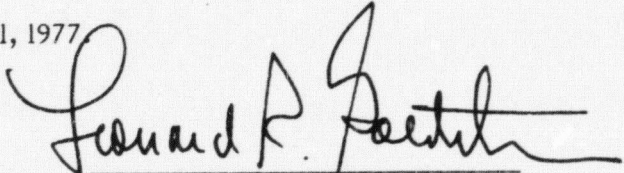
GOLDSTEIN, AHALT & BENNETT,
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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that copies of the foregoing Petition for Rehearing have been mailed to Charles J. Hecht, counsel for British American Commodity Option Corp., and Frederic T. Spindel, counsel for the Commodity Futures Trading Commission this 15th day of April, 1977.


LEONARD R. GOLDSTEIN

